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**working paper
department
of economics**

Balanced Budget Amendment

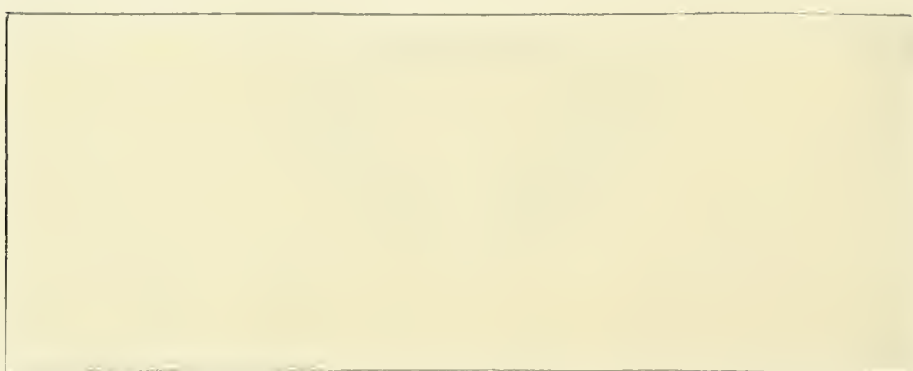
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No. 595

Nov. 1991

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Balanced Budget Amendment*

E. Cary Brown

November 1991

Abstract

Growing concern about budget deficits has led to many steps and proposals for their control, one of which is a constitutional amendment for a balanced budget.

The case for such action is the belief of its proponents that the budget process is dominated by minority pressures that require correction by constitutional requirement of a budget balance or expenditure-revenue limitations.

Opponents find no empirical support for this view of the budget process. They also argue that automatic and discretionary fiscal policies would be inhibited in a serious way and that the use of nominal budget data overstates in a major way the magnitude of the debt-deficit problem. Finally, they find that such an amendment would be unworkable and result in harmful and inefficient budget practices.

*Prepared for The New Palgrave Dictionary of Money and Finance.

Balanced Budget Amendment

Growing concern about budget deficits over the last two decades in the United States has led to many proposals for their control: budgetary reforms, statutory constraints, and constitutional amendments. The Budget Reform Act of 1974 promised major improvements in budget formulation by requiring Congress to confront simultaneously both the spending and taxing side of the budget. The Gramm-Rudman-Hollings law of 1985 established annual deficit limits (since revised several times) and certain automatic cutting procedures to achieve them. Since the mid-1970s political pressures have been exerted to add a balanced-budget amendment to the Constitution. Three times in the last decade such amendments have failed to secure the two-thirds majority of both chambers of Congress necessary to initiate the state-ratification procedure; 32 of the necessary 34 state legislatures have approved petitions to Congress to call a constitutional convention.

Proposed constitutional amendments have taken many forms. Some place quantitative limits on expenditures or revenues, in addition to or in lieu of the balanced-budget requirement. While sharply different in operation, they are still grouped under this one rubric; indeed, the balanced-budget movement has largely been diverted to one of government limitation.

The case for these amendments, made by its major intellectual proponents, is that present constitutional fiscal

procedures have failed. Expenditures after World War II exhibited explosive growth, while revenues did not keep pace. This growth could not be explained "solely in terms of a democracy's response to the demands of the citizenry, . . . [but instead] as the outputs of a political sector that has an internal dynamic of its own. . . ." (Buchanan 1980:82) Small groups intensely support particular programs, while taxes, spread thinly over the many, impose an extra cost too small to warrant their careful examination. Many of these taxes are hidden and may not be recognized as such. (Friedman 1980:123) Moreover, voters are short-sighted. "We can (and do) want this or that expenditure now, and yet we object to the total amount of spending to which our actions have contributed." (Wildavsky 1980:2) The consequent budget deficits reduce private-sector investment and enhance inflation.

Opponents of these amendments argue that the postwar record does not reveal this kind of voter behaviour. Schultze (1990) divided government expenditures into two categories--Social Security (including Medicare) and General Government (all other)--and related them to GNP. By decade averages he found that Social Security outlays grew from 1.3 percent in 1951-60 to 2.9 percent in 1961-70, 4.9 percent in 1971-80, and 6.5 percent in 1985. In contrast, General Government fell, respectively, from 16.9 percent to 16.3 percent, to 15.7 percent, then rose to 17.6 percent. "[I]t is [in] this 'general' category of government where the presumed bias toward excessive spending is supposed to

occur. . . . That simply did not happen." (Schultze 1990:65)

The second set of objections to balanced-budget amendments focuses on their constraints on fiscal policy. Waiving for the moment the problems of implementation, such constraints would depend, of course, upon their particular form. To illustrate, consider the proposed amendment that failed to pass the House in 1990 (but note that proposals designed solely to curb expenditures would be less of an impediment). The requirements of that amendment were: the President must submit a balanced budget with revenue estimates agreed to by Congress; Congress must approve a deficit budget, except in time of war, by 60 percent of the total membership of each chamber; Congress must approve an increase in revenues by more than the percentage growth of previous year's national income by a majority of the total membership of each chamber, whether or not the budget is in balance.

Automatic stabilization under the present revenue-expenditure structure could be seriously hampered in both expansions and contractions. Assume a budget-balance at high employment. If output fell, the automatic deficit would require approval by a 60 percent vote of the membership of both congressional chambers. Failing such a vote, the deficit would have to be eliminated by reduced expenditures (an ordinary majority vote), or by increased revenues (a majority vote of the membership). In an upswing, the more than proportionate increase in revenues to income would require approval by Congress (a

majority vote of total membership). If the vote failed, cuts in revenues would be necessary to reduce them to proportionality with income, and reduce their offsetting effect in the next downswing.

Discretionary fiscal policy in recessions, over and above automatic fiscal changes, would increase the deficit and thus require approval by 60 percent of total membership of both congressional chambers. In expansions, Congressional approval would be required for any revenue increases (a majority vote of total membership) and for expenditure reductions (a regular majority vote).

The conclusion seems clear that, if this proposed amendment were to operate as designed, stabilizing fiscal action would be harder to conduct in recessions than in prosperous times, with a heavier burden placed on monetary policy. If the Ricardian equivalence theorem held in its most extreme form, constraining depression fiscal policy would not matter (Barro 1989); but the same analysis also suggests that limitation on the size of the national debt is unimportant. Views on the efficacy of fiscal policy have been modified over the last half century, but its irrelevance is not yet an established consensus (see Dornbusch and Poterba 1990, and Eisner 1986).

A third set of objections to these amendments is their use of nominal expenditures and revenues and to the budget concept to which the requirement would be applied. Many steps could be taken to convert current nominal budget data to real terms,

depending on how broadly the net is cast in adjusting assets and liabilities (see Eisner 1986 for a thorough discussion). A minimal step would be to adjust governmental monetary assets and liabilities for changes in prices. The major factor here is the inflation component of interest payments that represents return of real capital. A second adjustment could eliminate the cyclical movements in the budget, thus making yearly comparisons consistent.

These two adjustments make a substantial change in the picture presented by nominal data, sufficient to cast doubt on the need for a constitutional amendment. Over the 39-year period, 1950-88, nominal budget outcomes (National Income and Product Accounts basis) recorded 11 years of surplus or near balance (≥ 0.2 percent of GNP), and 28 years of deficits. After cyclical and price adjustments the real budgets show 24 years of surplus or near balance, and 15 years of deficit, of which 7 happened after 1981 (Dornbusch and Poterba 1990:9-10).

Other budget concepts might be even more meaningful in measuring public resource use and current governmental cost, such as the capital budget which substitutes depreciation for expenditures on durable goods, but they have as yet been used only in special analyses by the federal government.

The last, and most serious, concerns are whether a workable constitutional amendment can be designed that would improve, not worsen, budget policy. Many students of budgeting, both pro and con a balanced-budget amendment, see daunting problems in making

these amendments effective; some have shifted support to an expenditure-limitation amendment. There are no unambiguous or generally agreed upon definitions of "budget", "receipts", or "expenditures". Governments may carry out programs in a wide variety of ways--through direct spending by government agencies, subsidies, tax expenditures, lending, government guarantees, and regulatory activities--that have dissimilar budget effects. The appropriate treatment of these various techniques could not be specified in a constitutional amendment without creating a monster bigger than the present Constitution, violating the standard of simplicity urged for such amendments (Buchanan and Wagner 1979:179).

While historically the budget has moved towards comprehensiveness, Congress determines the budget rules. Agencies such as Social Security and the Post Office are now off-budget, but are incorporated in the budget document. Tax expenditures--subsidies through the tax system--were estimated in the 1991 Budget at an expenditure equivalent of nearly \$500 billion. Federal credit and insurance programs (direct and guaranteed loans, government sponsored enterprises, and insurance) have doubled in the last decade to an estimated total of nearly \$6,000 billion, much of it off budget and a potential for avoiding budget constraints.

In addition to "creative" budgeting some foresee a growth in government regulatory activity, without reference to considerations of efficiency, stimulated by budget constraints.

Costs could be shifted by legislation to private enterprise or other government levels.

Three former Directors of the Office of Management and Budget (Ash 1990; McIntyre 1980; Schultze 1980ab, 1990) and Suits and Fisher (1985) were pessimistic about the operability of these amendments. Burns (1980) thought the design problems were sufficiently formidable to prevent the recommendation of a constitutional amendment, although he favored one in principle, and Stubblebine (1980), a strong exponent, seemed unsure of the functioning of such amendments. Wildavsky (1980:104) expected the benefits of an expenditure limit to outweigh these "end runs" that should be dealt with in any event.

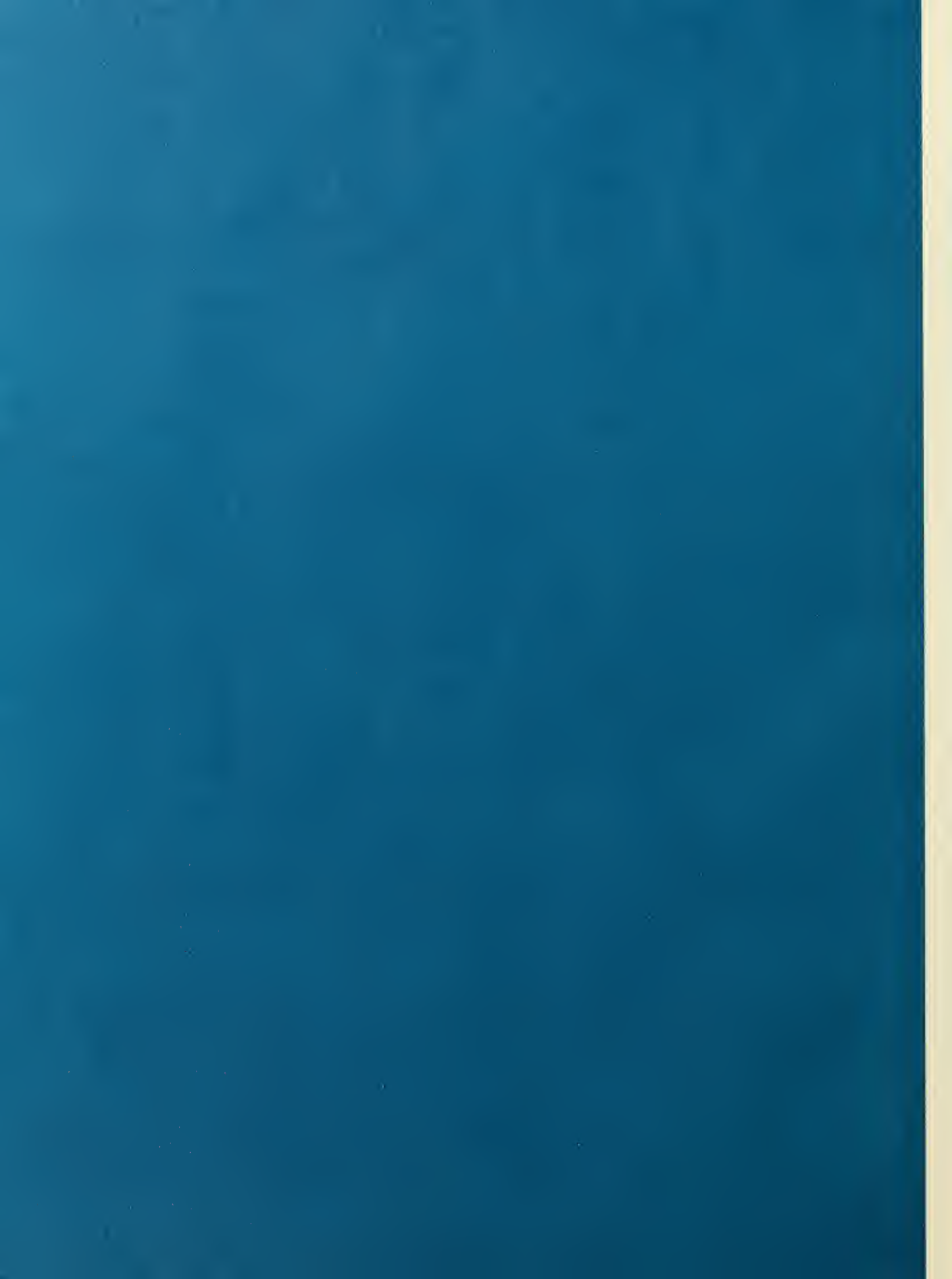
One can see why there is sharp conflict about a balanced-budget constitutional revision. This last decade has been a turbulent time for budget making: the White House and the Congress have been controlled by different parties with sharply different views on economic and social policy; entitlements, most of which are fully or partially indexed, represent a dominant, growing, and stubborn component of the budget; and slower economic growth has not provided the revenues and budget room of earlier periods (Schick 1990). With balanced budgets urged by all sides at present, the constitutional-amendment issue will not soon go away.

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